A Brief Overview of Business Types and Their Tax Treatment

Mark P. Keightley
Specialist in Economics

June 12, 2013

Congressional Research Service
7-5700
www.crs.gov
R43104

CRS Report for Congress
Prepared for Members and Committees of Congress

Summary

In the United States, how a business is taxed at the federal level is partly dependent on how it is organized. The income of subchapter C corporations, also known as "regular" corporations, is taxed once at the corporate level according to the corporate tax system, and then a second time at the individual-shareholder level according to the individual tax rates when corporate dividend payments are made or capital gains are recognized. This leads to the so-called "double taxation" of corporate income. Businesses that choose any other form of organization are, in general, not subject to the corporate income tax. Instead, the income of these businesses passes through to their owners and is taxed according to individual income tax rates. Examples of these alternative "pass-through" forms of organization include sole proprietorships, partnerships, subchapter S corporations, and limited liability companies.

This report summarizes the general tax treatment of corporate and pass-through businesses. The intent is to introduce those who are unfamiliar with the current U.S. business tax environment to the basics of corporate and pass-through taxation. Understanding how various businesses are taxed provides a starting point from which one can evaluate current and future proposals to change the taxation of corporations and pass-throughs. Additionally, since pass-through income is typically taxed only at individual income tax rates, this report is also a useful starting point for understanding the effects on pass-through businesses from a change to individual income tax rates. A list of related CRS products on business taxation may be found at the end of the report.

Contents

Introduction 1
C Corporations 3
Sole Proprietorships 4
Partnerships 5
S Corporations 6
Limited Liability Companies 7
Related CRS Reports 8

Figures

Figure 1. Distribution of Business Tax Returns Filed in 2009 2
Figure 2. Net Business Income By Business Type, 1980-2008 3

Contacts

Author Contact Information 9

Introduction

In the United States, how a business is taxed at the federal level is partly dependent on how it is organized. The income of subchapter C corporations, also known as "regular" corporations, is taxed once at the corporate level according to the corporate tax system, and then a second time at the individual-shareholder level according to the individual tax rates when corporate dividend payments are made or capital gains are recognized. This leads to the so-called "double taxation" of corporate income (profits). Businesses that choose any other form of organization are, in general, taxed only at the individual level. That is, the income of certain business types passes through to their owners where it is taxed at individual income tax rates. Examples of these alternative "pass-through" forms of organization include sole proprietorships, partnerships, subchapter S corporations, and limited liability companies (LLCs).[1]

This report provides a general overview of the tax treatment of the major business types, including sole proprietorships, partnerships, C corporations, subchapter S corporations, and limited liability companies. Important non-tax aspects of each business type are also presented and contrasted where appropriate. This report does not, however, address every issue (tax or otherwise) related to the major business types that could be of interest to Congress. Nor does this report discuss the tax treatment of all the organizational forms available to businesses, such as trusts, regulated investment companies (RICs), and real estate investment trusts (REITs).

Interest in the various business types available to U.S. companies has increased recently for several reasons. First, most corporate tax reform proposals offered to date include a reduction in the top corporate rate which currently stands at 35%. It is often proposed that the revenue loss from a reduced corporate tax rate could be offset (either fully or partially) with the repeal or reduction of certain business tax incentives, formally known as tax expenditures. Pass-throughs, however, could experience a tax increase if such an approach were followed. This is because most business tax incentives are incentives that are available to all businesses, not just corporations. Thus, offsetting a corporate rate reduction by curtailing business tax incentives could negatively impact pass-throughs, which do not pay corporate taxes, and therefore would not benefit from the corporate rate reduction.

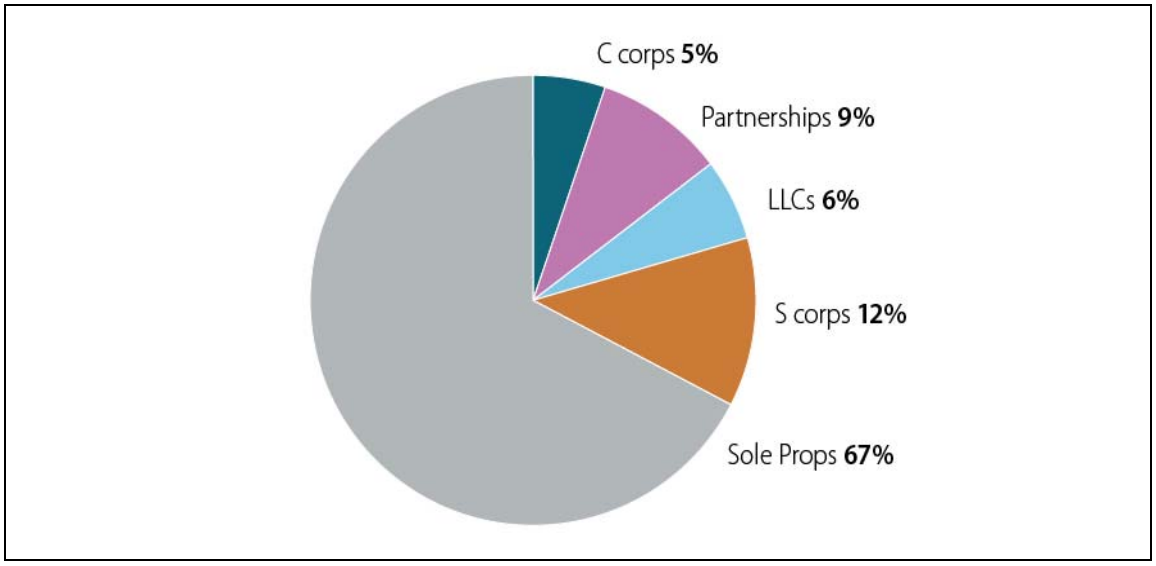
Second, a reduction in the top corporate tax rate without a corresponding reduction in the top individual tax rate could lead to an increase in the number of firms that incorporate to take advantage of the more favorable corporate rate structure. In late 2012, the top individual tax rate was increased above the top corporate rate for the first time since 2002 as the result of the American Taxpayer Relief Act of 2012 (P.L. 112-240).[2] Because pass-through income is taxed according to individual rates, a differential between the top corporate and individual tax rates can encourage firms to incorporate. If tax reform results in a lower corporate rate while leaving the top individual tax rate unchanged, the incentive to incorporate would increase.

[1] Sole proprietorships and single member limited liability corporations (LLCs) are technically disregarded entities. As the first paragraph notes, economists usually group these business types in with the pass-through businesses. For a disregarded entity there is no entity-level tax return, unless the LLC chooses to be taxed as a corporation. Unless the LLC files as a corporation, all income is reported on the individual's personal tax return, aggregated with other income, and taxed according to individual tax rates.

[2] The American Taxpayer Relief Act of 2012 increased the top individual tax rate from 35%, which was the same as the top corporate tax rate, to 39.6%.

And third, there have been off and on discussions about moving to a more uniform business tax environment. According to traditional economic theories of taxation there is no reason why otherwise identical businesses should be taxed differently. According to the same theories, when such differences do exist, the result is an inefficient allocation of resources, which occurs at the expense of stronger economic performance. The current tax disparity could be reduced via two general approaches. First, the corporate and individual tax systems could be combined or "integrated" so that corporations were treated similar to pass-throughs.[3] Second, pass-throughs could be subjected to the corporate tax.[4]

Figure 1. Distribution of Business Tax Returns Filed in 2009



Source: CRS Analysis of Internal Revenue Service, Business Tax Statistics, http://www.irs.gov/uac/Tax-Stats-2.

It is perhaps useful to briefly quantify the business landscape across the various business forms before proceeding. **Figure 1** displays the distribution of business tax returns filed in tax year 2009. The Internal Revenue Service (IRS) reports that there were approximately 29.5 million corporate and pass-through tax returns filed.[5] The majority (67%) were sole proprietorships. The

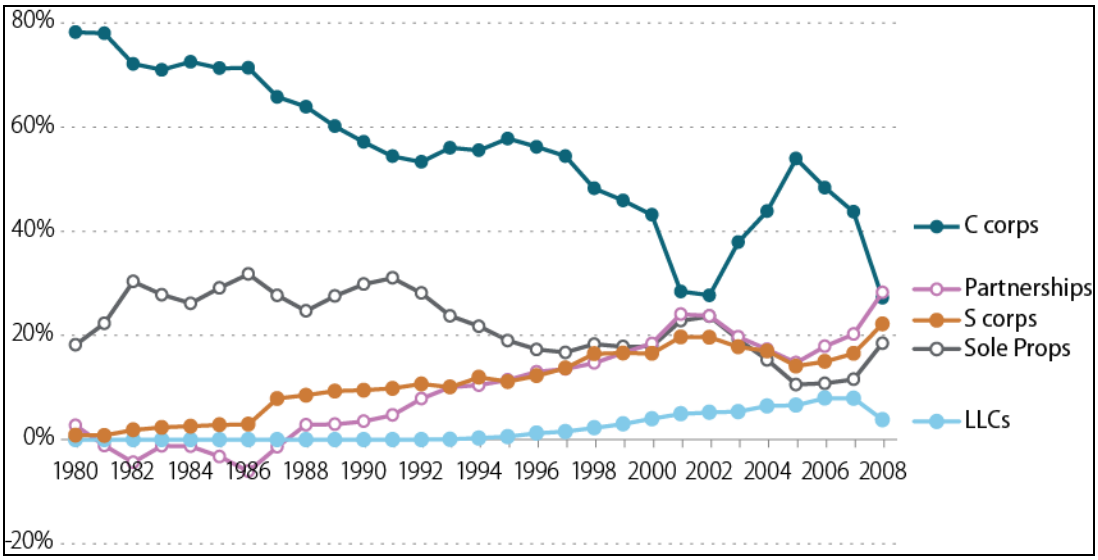
[3] In 1992, the Department of the Treasury drafted a 268-page report containing a comprehensive analysis of corporate and individual tax integration. See, The Department of the Treasury, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once*, Washington, DC, January 1992, http://www.treasury.gov/resource-center/tax-policy/Documents/integration.pdf. For a summary of the Treasury report, see R. Glenn Hubbard, "Corporate Tax Integration: A View from the Treasury Department," *Journal of Economic Perspectives*, vol. 7, no. 1 (Winter 1993), pp. 115-132.

[4] In early 2011, Senate Finance Committee Chairman Max Baucus suggested the possibility of taxing pass-throughs with earnings above a certain income as corporations. See, Nicola M. White and Drew Pierson, "Baucus Says Congress Should Look at Taxing Passthroughs as Corporations," *Tax Notes Today*, May 5, 2011. The Obama Administration also suggested such a policy change could be needed to lower the corporate tax rate in a report outlining the President's framework for business tax reform. See, A Joint Report by the White House and the Department of the Treasury Department, *The President's Framework for Business Tax Reform*, Washington, DC, February 2012, p. 10, http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf. House Ways and Means Committee Chairman Dave Camp, however, has expressed his opposition to such a policy change. See, Bernie Becker, "Members eager for White House tax plan," *The Hill*, May 4, 2011, Online edition, http://thehill.com/business-a-lobbying/159351-lawmakers-eager-for-white-house-tax-plan-.

[5] Internal Revenue Service, Tax Statistics, various tables, http://www.irs.gov/uac/Tax-Stats-2.

next most popular was S corporations (12%), followed by partnerships (9%), and LLCs (6%). C corporations comprised the smallest share of business returns filed (5%).

Figure 2. Net Business Income By Business Type, 1980-2008



Source: CRS analysis of Internal Revenue Service, Statistics of Income, Integrated Business Data, http://www.irs.gov/pub/irs-soi/80ot1all.xls.

Figure 2 displays the share of net business income generated by the various business types between 1980 and 2008. The most noticeable trend has been the decline in the share of income generated by C corporations.[6] At the same time, the shares generated by S corporations and partnerships have trended upward. LLCs have also slowly increased their share of business income since 1993, when LLCs first appeared as an option on the partnership tax form (this is discussed in the "Limited Liability Companies" section). Sole proprietorships appear to have possibly decreased in importance as a generator of business income, although it is difficult to conclude whether this decrease is the result of a cyclical downturn towards the end of the sample period, or a more permanent trend. In the end, **Figure 2** highlights the fact that pass-throughs are just as significant as corporations when it comes to economic activity.

C Corporations

A popular business structure is the corporate form, of which there are two types; C corporations, which are discussed in this section, and S corporations, which are discussed later. C corporations, also known as ordinary corporations, are named for Subchapter C of the Internal Revenue Code (IRC), which details their tax treatment. Businesses incorporate under state law and the exact requirements for incorporation may vary from state to state. Typically, a business must first file articles of incorporation at the state level in order to incorporate.[7] C corporations are considered

[6] For an in-depth analysis of why corporate tax revenues have fallen, see CRS Report R42113, *Reasons for the Decline in Corporate Tax Revenues*, by Mark P. Keightley.

[7] While a business may choose any state in which to incorporate, Delaware is by far the most popular. According to Delaware's Division of Corporations, 63% of Fortune 500 companies chose Delaware as their state of incorporation. (continued...)

to be an entity that is separate from its owners (shareholders) for legal purposes. As a result, shareholders are generally not legally liable for the actions of the corporation.

The corporate form of organization allows a business to take advantage of a number of benefits not available with other forms of organization. Specifically, a C corporation is not limited in the number of shareholders it may have, the classes of stocks it may issue, the types of shareholders it may have, or the citizenship of its shareholders. This is in contrast to the S corporations which are limited to one class of share they may offer, the types of shareholders, and the citizenship of its shareholders. Shares of C corporation stock are also traded on well-developed exchanges, which allows ownership interests to be transferred readily and at low transaction costs. As a result, C corporations have the ability to raise capital globally from a variety of investors.

For tax purposes, the distinguishing feature of a C corporation is that it is a taxable entity. A corporation's business income is subject to taxation at the corporate level according to the corporate income tax rate schedule. Any after-tax income that is then distributed to shareholders in the form of dividends or recognized as capital gains is taxed again at individual rates. This extra layer of taxation gives rise to what is known as the "double taxation" of corporate profits.

Because a corporation itself is a taxable entity and directly responsible for paying taxes, taxable income is computed at the corporate level. A corporation begins by aggregating all sources of business income to arrive at total income. Income sources include sales revenue, investment income, royalties, rents, and capital gains. To arrive at taxable income, the corporation then deducts business expenses and other special deductions. Deductions include such things as salaries and wages, bad debts, depreciation, advertising costs, and a portion of domestic production activities, among others. Corporations are also allowed to deduct interest paid to bond holders (but not dividend payments made to shareholders). As a result, corporations may rely more on debt financing than they otherwise would.

Like individuals, a corporation may be required to compute its income tax liability twice, once according to the regular corporate tax, and again according to the corporate alternative minimum tax (AMT). A corporation must pay the higher of the two taxes. The AMT is designed to guarantee that corporations are subject to a minimum rate of taxation by limiting the degree to which tax deductions and credits may be used to calculate tax liability.

Sole Proprietorships

A sole proprietorship is a business owned by a single individual and that is treated as identical with its owner for tax and legal purposes. The sole proprietorship is the most common and basic form of business organization. Unlike some other forms of business organization, a sole proprietorship does not limit it owner's liability. The business assets of the proprietorship as well as the personal assets of its owner may be used to settle any legal judgment against the business. In contrast, the limited liability protection provided by some other forms of business protects, to a certain degree, the personal assets of the business owners from judgments against the firm.

(...continued)

See http://corp.delaware.gov/.

The business income of a sole proprietorship is reported on a Schedule C attached to the owner's individual income tax return. The income is then taxed at the applicable individual income tax rates. Taxable business income includes net profits distributed to the owner as well as retained earnings. In addition, a sole proprietor is responsible for paying the self-employment tax. The self-employment tax rate is 15.3% and is composed of two parts: a Medicare tax (2.9%) and a Social Security tax (12.4%). In 2013, only the first $113,700 of self-employment income is subject to the social security portion of the tax. The tax is analogous to the combined employer's and employee's share of the Social Security and Medicare taxes, half of which is a payroll tax withheld by most employers.

Partnerships

A partnership is a joint venture consisting of at least two partners, with each partner sharing profits, losses, deductions, credits, and the like.[8] A partner is an investor in such an entity and may be an individual, a trust, a partnership, a corporation, another entity (such as a limited liability company), or a broker that is holding the ownership interest of an unnamed partner. Partnerships are established under the individual laws of each state, although their tax treatment at the federal level is determined by the Internal Revenue Code (IRC).

The most common partnerships include general partnerships, limited liability partnerships, and limited partnerships. A general partnership is one in which all partners are liable for the actions and debts of the business. That is, the business assets of the partnership, as well as the assets of the partners, may be used to settle a legal judgment against the business. A limited liability partnership (LLP) is a general partnership, usually a professional firm, in which the partners are mutually liable for the partnership debts but are protected from the harmful actions of the other partners. A limited partnership (LP) consists of at least one general partner and one or more limited partners. The general partners oversee the management of the business and are liable for the partnership's debts. The liability of the other partners is limited to their capital contribution and any additional amounts specified in the partnership agreement.

Partnerships themselves are not taxable; instead all tax items such as income, losses, deductions, and credits, pass through the partnership to the partners. The partnership reports each partner's allocation to the IRS and to the partners according to the partnership agreement. The partners then include their share of income or loss on their own tax return, even if there was no actual distribution of income to the partners. As long as there are no corporate partners, business income is taxed only at individual income tax rates. When a partnership does have a corporate partner, the share of income allocated to that partner will be reported on the corporate tax return.

Although the partnership agreement determines the final allocation of tax items to each partner, the partnership must distinguish between ordinary income and separately stated items when making the allocation. Some items must be stated separately because the partners may face limitations to the degree to which they may utilize certain tax items. For example, a capital loss may affect partners differently if some are able to use it to offset a capital gain. Separately stated items include capital gains and losses, dividends, tax-exempt interest, rents, royalties, deductions

[8] 26 U.S.C. §7701(a)(2) defines a partnership as "a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation."

attributable to portfolio income, charitable contributions, foreign taxes paid, and special allocation items determined by the partnership agreement. Ordinary income is the sum of income, gains, losses, and deductions that need not be separately stated.[9]

In addition to being entitled to a share of the partnership's profits or losses, partners may also be given guaranteed payments for their contributions of capital or service. Such payments are fixed and do not depend on the profitability of the firm. Fringe benefits such as health insurance are also considered a guaranteed payment. The partnership deducts guaranteed payments as ordinary business expenses, and the partners include them as ordinary income. To the extent that the guaranteed payments are for personal services performed by a partner, the income is subject to self-employment tax.

S Corporations

An S corporation is a "closely held" corporation that elects to be treated as a pass-through entity for tax purposes. S corporations are named for Subchapter S of the IRC, which details their tax treatment. By electing S corporation status, a business is able to combine many of the legal and business advantages of a C corporation with the tax advantages of a partnership.

Several criteria must be met if a corporation wishes to elect S corporation status. The corporation must be incorporated and organized in the United States. An S corporation can only issue one class of stock and is limited to no more than 100 shareholders.[10] The shareholders must be individuals, estates, certain types of trusts, tax-exempt pension funds, or charitable organizations. All shareholders must be U.S. citizens or residents. Certain banks, insurance companies, possession corporations (i.e., corporations predominately operating in a U.S. possession), and other select business operations are ineligible to elect S corporate status.

An eligible corporation that seeks S corporation status must file a timely election with the Internal Revenue Service (IRS). Each shareholder must consent in writing to the election. The shareholders agree to report and pay tax on their shares of the corporation's income. The election can be revoked with the consent of shareholders holding more than 50% of the outstanding shares of stock. If an S corporation election is revoked, the corporation cannot elect S status for five years without the consent of the IRS.

S corporations generally do not pay corporate-level income taxes. As with partnerships, operating income and loss are computed at the corporate level and passed through to the shareholders, while other items with special tax attributes are passed through separately. Separately stated items include portfolio income, capital gains and losses, passive income and losses, charitable contributions, foreign taxes paid, and the like. These tax items retain their character in the hands of the shareholders, who report allocations on their own returns, where the income is taxed for individuals. If the shareholder is a pass-through entity, the income is passed through the shareholder to the income beneficiaries of the pass-through entity.

[9] Kenneth E. Anderson, Thomas R. Pope, and John L. Kramer, et al., *Federal Taxation 2004: Corporations, Partnerships, Estates, and Trusts* (Upper Saddle River, NG: Prentice Hall, 2004), pp. D-6.

[10] Shareholders may, however, have different voting rights.

An S corporation is not afforded the same flexibility as a partnership with respect to allocations amongst its owners. Because an S corporation is only permitted to issue one class of stock, all allocations must be proportionate to ownership. This includes the portion of allocations that are separately stated. S corporation shareholders are not subject to self-employment taxes on items passed through the corporation. Like partners, shareholders who provide services to the corporation generally are employees of the corporation. The corporation may deduct as expenses wages, salaries, and some fringe benefits paid to these employees, but must also pay employment taxes and withhold income and payroll taxes.

An area of contention between S corporations and the IRS is the structure of employee-shareholder compensation. Compensation in the form of regular wages or salary is generally subject to payroll taxes and unemployment taxes. Dividend distribution, however, avoids these taxes. This provides an incentive for S corporations to pay and for employee-shareholders to receive dividends in lieu of wages or salary. The IRS has attempted to address this issue by reminding S corporations that they must pay "reasonable compensation" (subject to employment taxes) to shareholder-employees in return for services, before dividend distributions.[11] Compensation is considered reasonable when it matchers what the market return would be to the services provided by the employee. Failure to follow the IRS's suggestion could result in the reclassification of dividend compensation as wage or salary compensation for tax purposes.

An S corporation may be subject to the corporate income tax in certain instances. One such instance is the recognition of a built-in-gain. A built-in-gain is recognized when an S corporation, during the first 10 years of being an S corporation, disposes of an asset that had appreciated in value while the business was organized as a C corporation.[12] The tax rate on a built-in-gain is equal to the highest corporate tax rate (currently 35%). To the extent that built-in-gain exceeds the corporate tax owed on it, the built-in-gain passes through to shareholders who must report it as taxable income. Taxes may also be imposed to recapture previous benefits from the use of investment credits or the last-in-first-out inventory method by the C corporation. Finally, in instances where more than 25% of a converted corporation's gross receipts consist of "passive investment income," a corporate income tax may be imposed. The tax is equal to the highest corporate tax rate and is applied to net income attributable to the excess over 25% of gross receipts. Passive investment income includes such things as dividends, interest, rents, royalties, and capital gains.

Limited Liability Companies

A limited liability company (LLC) can combine the favorable tax treatment of a partnership with the limited liability features of a corporation.[13] An LLC, like a partnership, is provided the flexibility to allocate income, losses, deductions, and credits in an amount different than members' ownership interests.[14] The income of a C corporation, on the other hand, is generally

[11] Internal Revenue Service, *Paying Reasonable Compensation to the S Corporation Shareholder-Employee*, Stakeholder Headliners, vol. 32, Washington, DC, December 10, 2002.

[12] The American Recovery and Reinvestment Act of 2009 (P.L. 111-5) reduced the 10-year realization period to 7 years for gains recognized in 2009 and 2010.

[13] John E. Moye, *The Law of Business Organizations*, 6th ed. (Clifton Park, NY: Thomson Delmar Learning, 2004), p. 121.

[14] The owners of an LLC are referred to as "members."

distributed to its shareholders in a manner predetermined by rights inherent in each class of stock and the amount of each class of stock a shareholder owns. An S corporation is similarly constrained in the allocation of income, losses, and deductions to its shareholders.

LLCs, like corporations, are entities that are separate from their members or owners. As a result, members may not be responsible for the debts of the company.[15] There is no limit to the number of members an LLC may have, unlike with an S corporation. In addition, LLCs are permitted to have multiple classes of ownership interests.

LLCs are relatively recent creations. Wyoming was the first state to allow LLCs in 1977, followed by Florida in 1982.[16] By the mid-1990s, LLC laws had been enacted in all states.[17]

For many years, the IRS had held that any organization would be taxed as a corporation if it had the major characteristics of a corporation. LLCs were designed to lack enough corporate characteristics to avoid such a classification. In most cases, this was accomplished in one of three ways: having the company nominally cease to exist upon the withdrawal of a member; placing restrictions on the transferability of ownership interests; or designating all members as nominal managers.

In 1997, the IRS issued final regulations that in effect allow companies to elect how they will be taxed by simply checking a box on a form.[18] These regulations are typically referred to as "check-the-box" regulations. A single-member LLC can elect to be taxed as either a C corporation or a sole proprietorship. A multi-member LLC can elect to be taxed as either a partnership or a C corporation. These rules apply to any entity that is not otherwise required to file as a corporation or a trust. In general, a business may not change its classification during the 60 months following a check-the-box election.

Related CRS Reports

Below is a list of other CRS reports on corporate and pass-through taxation:

- CRS Report R42726, *The Corporate Income Tax System: Overview and Options for Reform*, by Mark P. Keightley and Molly F. Sherlock
- CRS Report R42113 *Reasons for the Decline in Corporate Tax Revenues*, by Mark P. Keightley
- CRS Report R42359, *Who Earns Pass-Through Business Income? An Analysis of Individual Tax Return Data*, by Mark P. Keightley
- CRS Report RL32254, *Small Business Tax Benefits: Current Law and Main Arguments For and Against Them*, by Gary Guenther

[15] If, however, the lender requires members to sign as individual members of the LLC, they could be responsible for the debt.

[16] Larry E. Ribstein, "The Emergence Of The Limited Liability Company," *The Business Lawyer*, November 1995, p. 1.

[17] Paul A. McDaniel, Martin J. McMahon, and Daniel L. Simmons, *Federal Income Taxation of Business Organizations*, 3rd ed. (New York: Foundation Press, 1999), p. 8.

[18] Treas. Reg. §301.7701-3.

- CRS Report R41988, *The Section 199 Production Activities Deduction: Background and Analysis*, by Molly F. Sherlock
- CRS Report R41852, *U.S. International Corporate Taxation: Basic Concepts and Policy Issues*, by Mark P. Keightley
- CRS Report RL34115, *Reform of U.S. International Taxation: Alternatives*, by Jane G. Gravelle
- CRS Report R42927, *An Analysis of Where American Companies Report Profits: Indications of Profit Shifting*, by Mark P. Keightley.

Author Contact Information

Mark P. Keightley
Specialist in Economics
mkeightley@crs.loc.gov, 7-1049